

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001

Statutory Review of the System
for Regulating Rates and Classes
for Market Dominant Products

Docket No. RM2017-3

**REPLY COMMENTS OF
THE NATIONAL POSTAL POLICY COUNCIL,
THE MAJOR MAILERS ASSOCIATION, AND THE
NATIONAL ASSOCIATION OF PRESORT MAILERS**

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(March 30, 2018)**

The National Postal Policy Council (“NPPC”), the Major Mailers Association (“MMA”), and the National Association of Presort Mailers (“NAPM”), collectively, the “First-Class Business Mailers,” hereby respectfully reply to the opening comments on Order No. 4258 (“*NPRM*”).¹

I. INTRODUCTION AND SUMMARY

The First-Class Business Mailers represent essentially the entire First-Class Presort Mail product, encompassing Automation and Non-automation letters, cards, and flats, and both mailer owners and service providers. We also probably account for as much or more Single-Piece mail than households, typically using Metered Mail or Residual Mail rates. Finally, we also mail a substantial volume of USPS Marketing Mail letters.

¹ By submitting these comments, NPPC does not waive its objections about Order No. 4257, for which it has filed a Petition for Review. *National Postal Policy Council v. Postal Regulatory Commission*, Case No. 17-1276 (D.C. Cir. order holding in abeyance Feb. 15, 2018).

Consequently, the First-Class Business Mailers have a vital interest in preserving a strong and viable postal system that provides high quality service at reasonable rates. We are concerned that the proposals in the *NPRM*, and additional proposals made by other commenters, would merely raise rates for market dominant products by potentially enormous amounts while doing little to improve the Postal Service's finances, its cost-effectiveness and efficiency, or the quality of its services necessary to keeping mail a viable, effective, and affordable medium for business communications and shipping needs.

Most fundamentally, we are concerned about the lack of focus on how much money the Postal Service truly needs to operate (as distinct from what it might have needed in the past), the Service's disinterest in or dismissal of any serious cost reductions or efficiency improvements, and the seeming absence of any plan to manage capital thoughtfully. As we explained in our March 1 comments, market dominant mail is not a piggybank for the Service's or unions' financial wish lists, nor can market dominant rates be raised to the levels proposed by the *NPRM* or the Postal Service without causing further, significant, and permanent, harm to already plummeting mail volumes.

A. The First-Class Business Mailers' March 1 Comments

In our March 1 comments, the First-Class Business Mailers showed that:

- The Commission does not have legal authority under the Postal Accountability and Enhancement Act or the Constitution to authorize rate increases above CPI-U except in exigent circumstances as provided in 39 U.S.C. Section 3622(d)(1)(e);
- The *NPRM* arbitrarily looks to "solve" the Postal Service's financial problems entirely from market dominant mailers while ignoring the growth and profitability of Competitive products;

- Simply throwing more dollars at the Postal Service without a serious effort to reduce costs, improve efficiencies, and manage capital assets more wisely conflicts with many Objectives of the PAEA and will fail. Stronger measures to maximize incentives to reduce costs and improve efficiency are essential;
- The proposal to improve pricing efficiency through Efficient Component Pricing of workshare discounts is an important step towards improved efficiency and cost reduction, and should be adopted with certain modifications;
- The revenue base resulting from the proposed supplemental 2 percent rate authority would continue in perpetuity, generating revenues far higher than the *NPRM*'s targeted average increase after the five year period of that extra authority;²
- Rate incentives should be linked directly to reductions in controllable costs, while Total Factor Productivity is a less desirable metric suitable merely for interim use if at all; and
- The proposal to link bonus rate authority to maintaining published service standards requires literally nothing from the Postal Service; any bonus should be based on actual performance in achieving those standards.

After reviewing the initial comments, we stand by our position that the current price cap system is both legally required and the most appropriate system, but that it can be made more effective. We address below certain points made in other initial comments.

B. Summary Of Rebuttal Points

One thing nearly every commenting party agrees upon is the need for legislative reform. Some commenters, however, would urge the Commission to ignore statutory limitations on its power, which the agency cannot do. The

² *Accord Netflix Comments* at 12-13 (stating that the supplemental two percent in years four and five should be temporary surcharges that are removed after the fifth year). We appreciate the concept, but fear that even two years at the excessive level would cause permanent damage to First-Class Mail volumes.

Commission is not the Congress, and cannot use the one tool that it has in a Section 3622(d)(3) proceeding – modifying its regulations that implement the price cap established by Congress -- to fill the vacuum created by Congressional inaction.

The Postal Service's renewed request for nearly complete deregulation of pricing of market dominant products was properly ignored before, is prohibited by Section 3642, and by deregulating a monopolist would be disastrous policy .

Within the general framework of the *NPRM*, however, the comments have demonstrated that the Commission must change course. Instead of relying on either net income in past years or levels of capital and investment from a different time and era, the Commission (if it proceeds along the lines of the *NPRM*) must tackle the difficult questions of:

- how much money the Postal Service needs to operate, taking into account the need for further cost reductions;
- how much capital it truly needs for investment, recognizing that the Service has smaller and declining mail volumes as compared to the pre-PAEA era;
- how much of those funds should be expected to come from growth in Competitive products, and how much should be extracted from captive market dominant mailers; and
- how much permanent damage would be inflicted by raising market dominant rates by more than inflation.

There is little disagreement over requiring Efficient Component Pricing in setting workshare discounts, and the proposals in the *NPRM* should be modified as described in our March 1 comments.

In contrast, there is almost universal criticism of the *NPRM*'s proposal to award bonus cap authority on improvements in Total Factor Productivity,

including from the Postal Service, mailers, and postal employees. That proposal should be abandoned. Any proposal to award efficiency improvements should be based on reductions in controllable costs, as our March 1 comments illustrated.

There is much criticism, and scant defense, of the proposal to award bonus cap authority on simply not changing published service standards and business rules. Any such award must be based on improvements in delivery service performance.

Other than for the proposal to require greater use of Efficient Component Pricing of worksharing discounts, the Commission does not have the legal authority to adopt the rate proposals in the *NPRM*, nor should it do so as a matter of sound policy.

If, nonetheless, the Commission wants to persist along the general lines of the *NPRM*, it should take sufficient time to perform the necessary analyses necessary to get it right, and issue a further Notice of Proposed Rulemaking that takes better account of the concerns raised in our March 1 comments and these reply comments.

II. ONLY A LEGISLATIVE SOLUTION CAN ADDRESS THE FINANCIAL ISSUES OF CONCERN TO THE COMMISSION

When Congress enacted the PAEA in late 2006 it made certain assumptions about volume growth in the years to come. One was that volume growth would enable the Postal Service to prefund retiree health benefit

premiums and make other retiree-related payments. That proved incorrect.³

Unfortunately, as the Public Representative pointed out, “[w]ith hindsight, it is clear that fundamental assumptions underlying the PAEA were incorrect.”⁴

Volume went down, not up, as broadband Internet, mobile devices such as the iPhone, and wireless technologies dramatically changed the world in which the Postal Service operates. As communication needs grew enormously, so too did text messaging, social media, and voice communications, and the Postal Service’s share of the message market shrank.

But the law did not change. As volumes declined, the Postal Service made the prefunding payments for several years, but since 2012 has defaulted on the RHB and, in FY 2017, pension payments as well. Thus, the prefunding mandate converted “what had been a manageable long-term retiree health liability into a short-term cost that USPS simply could not – and cannot – afford.”⁵ As the Commission noted in Order No. 4257 (at 171), the “accumulated deficit of \$59.1 billion includes \$54.8 billion in expenses related to prefunding the RHBF.”

³ The \$3.1 billion surcharge added in Docket No. R2005-1 was, at that time, intended to fund an escrow related to the Postal Service CSRS. See *Opinion and Recommended Decision*, Docket No. R2005-1, at ¶3001 *et seq.* (Nov. 1, 2005). Mailers agreed to settle that case for that purpose. That increase became a permanent part of the rate base and has never been rescinded. The PAEA redirected those escrowed funds to be a partial prepayment of the retiree health benefit premiums. PAEA, Section 801, 5 U.S.C. §8348(h); see also *2011 Section 701 Report*, at 16. Mailers have now paid a cumulative amount in excess of \$33 billion over the years for this purpose, and have never consented to have it diverted to other purposes. As there was never a dedicated account for that money, there is no way to tell how the Service spent it. In theory, that money should have covered much of the prepayment obligation.

⁴ *Public Representative Comments* at 1.

⁵ *National Association of Letter Carriers, AFL-CIO Comment* at 2.

As a percentage, the prefunding mandate accounts for more than 90 percent of the net losses that the Postal Service has incurred since 2007.⁶

Consequently, by GAAP accounting the Service technically shows a negative balance sheet, although it has sustained operations without interruption.⁷ It is largely this GAAP-based balance sheet that led the Commission to conclude that the Postal Service is not financially stable (at least in what the Commission styles the “medium” term and “long” term), and to issue the *NPRM* in an attempt to “fix” the Postal Service’s GAAP net income and balance sheet. But, as explained in our March 1 comments, Congress’s direction in Section 3622(d)(3) that the Commission review, after a decade, the regulations that the agency adopted to implement the price cap system established by the PAEA did not give the agency authority to make the sweeping changes proposed in the *NPRM*.⁸

We agree with the majority of commenters that the perceived financial problem has arisen because of how Congress wrote the PAEA, and only the

⁶ *NALC Comment* at 2. See also Office of the Inspector General, *Peeling the Onion: The Real Cost of Mail*, Report No. RARC-WP-16-009 at 16-17 (April 18, 2016) (stating that the RHB prefunding requirement is “primary source” of the deficits).

⁷ This \$59 billion deficit is misleading, because it records the Postal Service’s substantial real estate assets at net depreciated, not market, value, and ignores that its retirement funds have very large balances sufficient to make payouts for years.

⁸ See *First-Class Business Mailers Comments* at 19-41. The *ANM et al.* concurred. Nothing in the Postal Service’s comments on this issue raised any arguments not previously addressed adequately. Neither set of comments raises any material issue regarding the Commission’s limited legal authority under Section 3622(d)(3), and we see no need to address this issue in these reply comments. The Public Representative (at 7-9) discusses *Chevron* analysis, but raises no new issue. The *NPRM* does not contend that the statute is ambiguous.

Congress appropriately can remedy it.⁹ As Vice Chairman Acton has noted, the Commission cannot “allow the Postal Service to reamortize unfunded liabilities, administer employee benefits differently, change the frequency of delivery, or deliver profitable items restricted by statute.”¹⁰ Even a solution as simple as expanding the investment options available for the Postal Service’s retiree funds – which would go farther to reduce the funding obligations and balance sheet debt than anything this Commission might do even if it had the authority claimed by the *NPRM* -- would require legislation to achieve.¹¹

If, after reflection, the Commission concludes that the underlying problem here is that the PAEA simply no longer works as intended due to developments in the market, then it should tell Congress that, as it has done previously. But the highly regrettable lack of legislative action to date does not empower the Commission to assume the authority to make changes that would effectively rewrite the statute piecemeal.

In particular, the Commission cannot solve what it perceives as the Postal Service’s financial problem through a proceeding confined to a review of only the regulatory system governing the rates only for market dominant products. The sole focus of this review is the Commission’s regulations implementing the

⁹ *ACMA Comments* at 5. The ACMA goes on to point out that if the Commission were to act aggressively, it would usurp the role of Congress to set postal policy. *Id.*; *American Forest & Paper Association Comments* at 6 (“The underlying deficit on the USPS balance sheet due to the RHB prefunding requirements should be up to Congress to solve”).

¹⁰ *NPRM*, Supplemental Views of Vice Chairman Mark Acton.

¹¹ *E.g.*, *Consumer Postal Council Comments* at 4. It is well known that these funds do not earn a market-level interest rate, or even the assumed rate. In FY2016, the assumed rate of return for both the CSRS and FERS funds was 5.5 percent, but the actual rates were 4.04 percent and 3.04 percent, respectively.

statutory price cap system governing the rates of the Postal Service's declining business of market dominant products.

A carpenter working in a new house lacks authority to call in architects to redesign the house; that responsibility belongs to the owner. The carpenter's job is to install the framing and trim according to the blueprints with the tools available; it is not to construct a wooden fireplace just because it thinks the one in the plans is deficient. So too the Commission cannot fix the problems inherent in the PAEA in a proceeding limited to a review of only one segment of the Postal Service's business.

Congress assigned the Commission to regulate market dominant rates in order to protect mailers subject to the postal monopoly and mailbox rule. Its role is protect those mailers, not to serve a doctor for all of the ills besetting the Postal Service. Only Congress can serve that role.

III. THE POSTAL SERVICE'S ALREADY REJECTED PLEA FOR DEREGULATION IS BARRED BY THE PAEA

The Postal Service's comments renew its plea for what amounts to deregulation of market dominant rates via what it euphemistically calls a "regulatory-monitoring approach."¹² The Commission implicitly rejected that proposal by not adopting it in the *NPRM*, and properly so. The Postal Service's proposal is contrary to the statute, and its plea that it can be trusted not to abuse unlimited pricing authority is refuted by its own comments. Those comments argue that the Commission has grossly underestimated the amount of additional

¹² *USPS Comments* at 40-48.

money needed, but present no plans or controls to manage any extra dollars or reduce current costs or provide any other reason to trust its assurances.

A. Section 3642 Does Not Allow Deregulation Of Market Dominant Products Subject To The Monopoly Or Over Which The Postal Service Has Market Power

The Postal Service's proposal would effectively deregulate its rates for market dominant products by allowing it to "increase rates at regular intervals" without Commission review, subject neither to any price cap nor to approval before the new rates would take effect (that is, no *ex ante* review). Instead, mailers would receive only vague "forward-guidance" in a way that the Service imagines would allow mailers to budget for rate increases. *Id.*¹³ The Postal Service asserts that "market incentives" would keep its rates acceptable.¹⁴ Whatever Commission review would remain (which the Postal Service somehow calls "robust" despite its being eviscerated) would occur only in the Annual Compliance Review under Sections 3652 and 3653.

This thinly veiled request by the Postal Service for almost total deregulation cannot and should not be approved. It is prohibited by the PAEA and by the Administrative Procedure Act, and would be extremely poor policy.

Taking the latter first, the Postal Service's proposal is far outside of the scope of the Commission's *NPRM*. While the Postal Service did urge the

¹³ The Postal Service offers no explanation for why a forward guidance model based on the Federal Reserve Board's Federal Open Market Committee would have any relevance for market dominant postal rates.

¹⁴ *USPS Comments* at 79 (stating that "Its actual pricing decisions will be informed by changes in demand and by other market forces, which alone impose adequate real-world incentives to increase efficiency and reduce costs in an increasingly challenging environment").

Commission to surrender its regulatory oversight in this manner in its Phase 1 comments, the *NPRM* wisely rejected such deregulatory schemes and chose instead to retain a version of a price cap. Adoption of the Postal Service's renewed request would not be a "logical outgrowth" of the *NPRM*. *Long Island Care at home, Ltd v. Coke*, 551 U.S 158 (2007) (*NPRM* gave notice it was "considering" a change); *Kooritzky v. Reich*, 17 F.3d 1509 (D.C. Cir. 1994) (invalidating new rule where *NPRM* gave no indication that agency was considering particular change).

The Postal Service's request is also barred on substantive grounds. Its request for deregulation is tantamount to the transfer of the entire market dominant product list to the Competitive category. Congress has established the law that governs such transfers. In particular, Section 3642 provides:

(a) In General.—

Upon request of the Postal Service or users of the mails, or upon its own initiative, the Postal Regulatory Commission may change the list of market-dominant products under section 3621 and the list of competitive products under section 3631 by adding new products to the lists, removing products from the lists, or transferring products between the lists.

(b) Criteria.—All determinations by the Postal Regulatory Commission under subsection (a) shall be made in accordance with the following criteria:

- (1) The market-dominant category of products shall consist of each product in the sale of which the Postal Service exercises sufficient market power that it can effectively set the price of such product substantially above costs, raise prices significantly, decrease quality, or decrease output, without risk of losing a significant level of business to other firms offering similar products. The competitive category of products shall consist of all other products.

(2)Exclusion of products covered by postal monopoly.—

A product covered by the postal monopoly shall not be subject to transfer under this section from the market-dominant category of mail. For purposes of the preceding sentence, the term “product covered by the postal monopoly” means any product the conveyance or transmission of which is reserved to the United States under section 1696 of title 18, subject to the same exception as set forth in the last sentence of section 409(e)(1).

(3)Additional considerations.—In making any decision under this section, due regard shall be given to—

(A) the availability and nature of enterprises in the private sector engaged in the delivery of the product involved;

(B) the views of those who use the product involved on the appropriateness of the proposed action; and

(C) the likely impact of the proposed action on small business concerns (within the meaning of section 3641(h)).

39 U.S.C. 3642.

It is clear that the Postal Service cannot pass either part of this test, much less both, as required. Considering first Section 3642(a), the Service clearly has the power to raise prices substantially above cost (one need look only to the cost coverage for First-Class Presort Mail, the implicit coverage for Metered Mail, and the cost coverage of most Marketing Mail products), and it can do so without losing mail to physical competitors because there are none.

That is why Section 3642(b) flatly prohibits the transfer to the Competitive category of mail that is covered by the postal monopoly. That

alone erects a legal bar to the transfer of First-Class Mail and Marketing Mail to the Competitive side.¹⁵

Nor can the Postal Service achieve indirectly (by replacing the substance of market dominant regulation with the substance of Competitive product regulation) what it is barred from obtaining directly. The Postal Service implicitly is asking the Commission to bypass Section 3642 and to reach what amounts to the same outcome through the 10-year review. But this it cannot do.

Nothing in the Section 3622(d)(3) review empowers the Commission to circumvent other PAEA provisions. Furthermore, to the extent that the Commission can incorporate other policies of the PAEA in this proceeding,¹⁶ it can do so only to effectuate them, not override them. Both Sections 3622 and 3642 were enacted as part of the PAEA, and the *NPRM* notes that “each part or section should be construed in connection with every other part or section to produce a harmonious whole.” *NPRM* at 158, *quoting* Sutherland Statutes and Statutory Construction § 46:5 (7th ed. 2014). The policies of Title 39 require adherence to the letter and spirit of Section 3642, and do not allow the deregulation in practice of the Postal Service’s rates for market dominant products through the subterfuge of the Section 3622(d)(3) review.

¹⁵ We do not purport to apply the Section 3642 test to Periodicals Mail.

¹⁶ See 39 U.S.C. § 3622(c)(14); Order No. 4257 at 51-52 & 157-158 (referring to 39 U.S.C. § 1005(d)(1) as support for considering RHB, FERS, and workers’ compensation funding obligations).

B. Experience Teaches That *Ex Ante* Review Of Rate Adjustments Is Necessary

Prior review of general market dominant rate adjustments remains essential today. By 39 U.S.C. 3681, mailers may not obtain refunds of rates subsequently found unlawful; accordingly, were rates allowed to take effect without such review, mailers potentially could be forced to pay billions of dollars that they could never recover.

During the PAEA period, there have been relatively few occasions in which the Commission has found, during its *ex ante* review of noticed market dominant rate adjustments, a particular proposed rate to be unlawful and thus blocked it from taking effect. However, this has occurred. Perhaps the most notorious example occurred in Docket No. R2015-4, in which the Commission found certain proposed prices for Standard Mail, Periodicals, and Package Services to be noncompliant with legal requirements and remanded them to the Postal Service for correction. *Order on Price Adjustments for Standard Mail, Periodicals, and Package Services Products*, Docket No. R2015-4, at 2 (Mar. 6, 2015) (Order No. 2378).¹⁷ But for this prior review, those mistakes would not have been corrected, and mailers would have been charged unlawful rates for nearly two years until the Docket No. R2017-1 rates took effect two years later.

¹⁷ The errors included incorrect adjustments to billing determinants, failure to provide appropriate justifications for new workshare discounts in excess of 100 percent pass-throughs, and simple calculation errors. Deregulation of the type urged by the Postal Service would not affect the relevance of these issues (for example, the Service needs accurate billing determinants for reasons beyond simply cap compliance), but it would prevent them from being corrected.

In contrast, the First-Class Business Mailers are unaware of a single instance in which the Commission in an Annual Compliance Determination has ordered the Postal Service to change a market dominant rate immediately. Even in the case of Standard Mail flats, the Commission merely directed the Postal Service to take steps to improve the cost coverage of that product in subsequent rate adjustments. And although the Commission occasionally finds a few workshare discounts to be out of compliance with Section 3622(e), it typically directs the Postal Service to bring the rate into compliance in the next rate adjustment or justify an exception at that time.

While the First-Class Business Mailers are not herein disputing the wisdom of those decisions at those times, the relevant point is that the Commission has never disallowed a rate or ordered an immediate change in an ACD. And this history gives no reason to expect that it would start to do so if it granted the Postal Service's request for deregulation.

C. Experience Teaches That The Postal Service Will Raise Rates Dramatically Once Allowed To Do So

The Postal Service states that “market pressures” would give the Postal Service ample reason to provide stable prices lest mailers abandon the mailstream.¹⁸ Count the First-Class Business Mailers as highly skeptical.

The Postal Service wants the Commission to overlook that, in its very same comments, the Service advocated an immediate 3.3 percent rate increase – amounting to about \$5 billion annually – as the “absolute minimum estimate of

¹⁸

USPS Comments at 43.

the amount by which the Postal Service's revenue baseline should be increased."¹⁹ It also said that a "more realistic assessment" of its annual financial performance would require a \$5.7 billion, or 3.8 percent, increase instead of the supplemental 2 percent increase proposed in the *NPRM*.²⁰

We have seen this movie about Postal Service promises before. Just last summer, the Commission approved the transfer of the First-Class Package Services Retail product to the Competitive category. *Order Conditionally Approving Transfer*, Order No. 4009, Docket No. MC201507, at 33 (July 20, 2017). In so doing, the Commission credited the Postal Service's claim that the product had a small market share and "from a business standpoint, the Postal Service cannot raise FCRP prices above those for competing products offered by UPS and FedEx without losing business" other than an increase intended to ensure Private Express Statutes would not apply).²¹

Upon approval of the transfer, the Postal Service immediately raised the rates by 9.9 percent. *See Decision of the Governors of the United States Postal Service on Changes in Rates of General Applicability for Competitive Products* (Governors' Decision No. 16-9) (presumably this was the amount needed to ensure that the Private Express Statutes did not apply). Moreover, the Postal Service shortly thereafter raised the rates by an additional average of 14.5 percent. *See Decision of the Governors of the United States Postal Service on*

¹⁹ *Id.* at 60.

²⁰ *Id.* at 62.

²¹ *USPS Response to Chairman's Information Request No. 2*, Docket. No. MC2015-7, Attachment 2 (June 26, 2017).

Changes in Rates of General Applicability for Competitive Products (Governors' Decision No. 16-10) at 1 & Order No. 4154, Docket No. CP2018-8, (Oct. 10, 2017).

D. The Postal Service's Comparison To Royal Mail Compares Apples To Oranges

The Postal Service points to the Royal Mail as an example of a post office that has operated successfully under a deregulated model of the type that it favors "after an initial true-up."²² The comparison is simply inapt.

First, it is not clear to what exactly the Postal Service is referring to as the "initial true-up," but in 2012, after Ofcom relaxed its rate regulations, the price of a First-Class letter rose from 46 pence to 60 pence, and a Second-Class letter from 36 pence to 50 pence. These were rate increases of 30.4 and 38.8 percent, respectively. Small wonder the Postal Service chose not to mention the size of the "true-up." And although the Postal Service claims that Royal Mail rate increases have held near inflation since that "true-up," other commenters noted that the rate for a 100 gram first-class letter increased between 2007 and 2016 by 88.2 percent.²³

Second, Royal Mail has been a private company since its shares were offered in 2013, and the British government disposed of its last shares in 2015. It no longer has any governmental ownership. Instead, unlike the Postal Service, it has private shareholders who are in a position to demand that management

²² See *USPS Comments* at 39.

²³ *ANM et al. Comments* at 51, citing Office of the Inspector General, *Lessons in Price Regulation from International Posts*, Report No. RARC-17-003 (Feb. 8, 2017).

engage in serious and sustained cost management. If the Postal Service were ever privatized, the analogy to Royal Mail might have relevance, but that is certainly not the case here.

Third, the British government assumed the Royal Mail's pension assets and liabilities, including funding obligations, in the 2011 Postal Act. Obviously, the United States government has not done so for the Postal Service's pensions.

Fourth, the Royal Mail's employee healthcare is addressed by the national healthcare system, which is paid for by taxes, not postage fees. Unless and until the United States adopts a single-payer system, or assigns *all* postal employees to Medicare, the Postal Service will continue to bear the healthcare costs of its employees and a sizable proportion of its retirees. The Postal Service would have a rosier financial outlook without pension or healthcare obligations.

Finally, it is worth noting that the Postal Service is not consistent as to whether comparisons to Royal Mail are useful. Although its comments in this proceeding favor such comparisons, the Service took a much more negative view when, in 2017, the Government Accountability Office suggested that removing the postal monopoly might spur it to greater efficiency.²⁴

If the Postal Service were a private firm with its healthcare and pension obligations covered by the government, analogies to the Royal Mail might have relevance. But it is not, so they do not. The Postal Service and Royal Mail are

²⁴ *U.S. Postal Service: Key Consideration for Potential Changes to USPS's Monopolies*, GAO Report 17-543, Appendix 3 at 41 (June 2017) (Postal Service comments stating "there is no reason to believe that any of the supposed efficiency effects described in the draft report [attributed by GAO to Royal Mail's privatization] have any bearing whatsoever on the Postal Service").

very different organizations with very different sizes and very different obligations, and comparing them truly is to compare apples and oranges.

IV. BREACHING THE STATUTORY PRICE CAP PROTECTING MARKET DOMINANT MAILERS WITHOUT FIRST DETERMINING HOW MUCH MONEY THE POSTAL SERVICE ACTUALLY NEEDS WOULD BE ARBITRARY AND CAPRICIOUS

The Postal Service, joined by its employee groups and the Public Representative, contends that the Commission's targeted \$2.7 billion in "supplemental" revenue is "woefully insufficient" and not "designed around" its financial situation.²⁵ They share a common contention that in basing the target amount for the "supplemental" revenue on the net income (loss) in FY 2017, the Commission had failed to reach deeply enough into mailers' pockets.²⁶ Using various theories, they urge the Commission to allow the Postal Service to raise rates by as much as 10 percent immediately and to tack on a variety of "exogenous" surcharges that would enable the Postal Service to raise rates even higher.

These requests for even higher rate increases should be rejected outright. They suffer from numerous shortcomings, beginning with that they are premised on the *NPRM*'s faulty definition of financial stability. The Postal Service and its

²⁵ *USPS Comments* at 53. As noted above, statements like these cause mailers to doubt the Postal Service's "assurances" that market pressures would prevent it from raising rates. Regardless of what current management may say, they will not occupy their current positions forever, and in any case whether to adjust rates is the prerogative of the Governors, not the postal executives. *Accord NALC Comment* at 19.

²⁶ Persistently pessimistic, the Postal Service dismissed its relatively better financial performance in FY 2017 as an "outlier" and asked for \$5.7 billion. *USPS Comments* at 57; see *generally id.* at 52-61. The APWU, perhaps anticipating its upcoming collective bargaining negotiation, asked for nearly \$5 billion. *APWU Comments* at 1-2 & 7. Less modestly, the NALC demanded an immediate 10 percent increase. *NALC Comment* at 4.

supporters compound that error by basing its future revenue needs not on what combination of revenue and cost reductions will best allow it to maintain and develop postal services suitable for the nation, but on the Service's financial results in past years. And they, like the *NPRM*, completely ignore the revenues from Competitive products and argue that a \$70 billion organization is simply unable to improve its productivity.

The Public Representative argues that the Commission's choice of the \$2.7 billion target revenue amount was arbitrary and in violation of the Administrative Procedure Act.²⁷ We agree that the \$2.7 billion was arbitrary, but for different reasons.

As we explained in our March 1 comments, the Commission has made no effort to determine how much revenue (or capital) the Postal Service needs in order to provide "postal services of the kind and quality adapted to the needs of the United States" going forward (because that is when the new rates would be in effect), nor has it determined how much net income should come from rates as compared to cost reductions, nor how much should come from Competitive products. If one ignores the decade of revenue growth in Competitive products and assumes little in the way of improved cost control, it is easy to paint a dismal financial picture for the Postal Service. But that is not reasoned decision-making. The First-Class Business Mailers respectfully submit that determining how much money the Postal Service needs, and from whom it will come, is an absolute

²⁷ The Public Representative contends that the Commission's use of \$2.7 billion is arbitrary because it lacks a reasoned explanation of how it dealt with historical financial numbers. We contend that the Commission would be acting arbitrarily because it is not attempting to determine how much money the Postal Service will need in the future.

condition precedent to any attempt to allow the Postal Service to exceed the statutory price cap.

A. The Commission’s Non-Statutory Definition Of “Financial Stability” Has Focused Attention On The Wrong Inquiry

In our March 1 Comments, we pointed out that both Order No. 4257 and the *NPRM* are flawed because they employ a definition of the Objective 5 term “financial stability” that is untethered to any statutory language. The Commission’s approach relies on concepts of its own making regarding short-term, medium-term, and long-term financial stability, while discarding the only language in Section 3622 that states what Congress meant by “financial stability.”

That language appears in Section 3622(d)(1), the exigency provision, in which Congress authorized the Commission to approve above-cap rate adjustments due to extraordinary or exceptional circumstances where:

Such adjustment is reasonable and equitable and necessary to enable the Postal Service, under best practices of honest, efficient, and economical management, *to maintain and continue the development of postal services of the kind and quality adapted to the needs of the United States.*

39 U.S.C. §3622(d)(1)(E) (emphasis added). This provision allows the Postal Service to be made whole by compensating “for the net adverse financial impact of the exigent circumstances.” Order No. 864, Docket No. R2010-4R, at 25 (Sept. 20, 2011); *United States Postal Service v. Postal Regulatory Commission*, 640 F.3d 1263, 1268 (D.C. Cir. 2011) (“adjustments must match the amount of the revenue lost as a result of the exigent circumstances”). Because the exigency provision sets the standard by which the Postal Service is to be made

whole, the standard in the exigency provision *must* represent the normal financial condition.

Additionally, the Section 3622(d)(1) definition of “financial stability” focuses attention on the only important question going forward: how much money is needed “*to maintain and continue the development of postal services of the kind and quality adapted to the needs of the United States.*” This definition properly the focus on postal operations going forward,²⁸ rather than on less relevant concerns such as how much money the Postal Service happened to have on hand in 2006, 2012, 2017 or any other year or the existence of any retained earnings.²⁹ It also illustrates the irrelevance of the Public Representative’s concern about the Commission’s conclusions in Order No. 4258 about “short-term” financial stability, a matter having little relevance to financial requirements going forward.

In contrast, the standard invented in Order No. 4257 and repeated in the *NPRM* lacks a sound statutory grounding. The lack of a sound definition leaves the door wide open for the Postal Service and postal unions to demand ever-more money; when the definition has no statutory grounding, creative minds can argue for just about any number.

²⁸ *Accord Comments of the American Forest & Paper Association* at 6 (“We believe the PRC focus should be USPS financial health based on revenues needed to support ongoing operations”); *ANM et al. Comments* at 109: “The Commission should focus on how much money the Postal Service needs to meet its present and likely future obligations to its retirees, not how much money would be required in the (counterfactual) assumption that the Postal Service could somehow catch up with the absurd prefunding schedule that PAEA purported to impose.”

²⁹ It should be noted that the term “retained earnings” is not equivalent to “cash on hand,” but rather is a measure of how an entity has managed its profits (or lack thereof), including whether they are distributed as dividends or reinvested. A lack of retained earnings in an entity with positive cash flow is an indicator that costs are excessive.

In our March 1 comments, we pointed out that if the Commission were to apply the correct definition, it would have to conclude that the Postal Service is financially stable. The Service has, in fact, “maintained and developed” postal services designed for the needs of the nation, the mail has been delivered to more delivery points than ever before, and the Postal Service has introduced pricing innovations, invested in new equipment, and redesigned its network to support the volumes anticipated in the future. We nonetheless noted that the Service could do more meet the “economical” and “efficient” elements of the standard.

The Commission should reconsider its invented definition of “financial stability” and return to one based on the statutory text. That will help focus its attention on the issues that truly matter.

B. The Commission Must Determine How Much, If Any, Additional Revenue The Postal Service Really Needs To Be Financially Stable

The uninhibited revenue demands presented by the Postal Service and others contrasts dramatically with the comments of mailers who noted that plenty of room remains for serious cost reductions. If the Commission is inclined to persist in its unsound proposal to allow the Postal Service to exceed the statutory price cap, this wide range makes evident that it must first determine how much additional revenue (if any) the Postal Service really needs in order to continue to “maintain and develop” postal services for the nation.³⁰

³⁰ Thus, in a sense we agree, but on different grounds, with the Public Representative that the proposed supplemental 2 percent authority lacks an underlying analytic principle. *See PR Comments* at 15-16. That is a symptom of the flaw in the Commission’s financial analysis.

There is also a transparency issue here. The Commission noted earlier this very week: “For market dominant products, there is substantial public interest in maintaining financial transparency because, by definition, the Postal Service is able to exercise market power over market dominant customers.” Order No. 4451, Docket No. ACR2017 at 22 (Mar. 28, 2018). As noted above, mailers agreed, in settling the Docket No. R2005-1 rate case, to a \$3.1 billion increase in the rate base to fund the CSRS, which the PAEA diverted to the RHBF. Mailers have since paid more than \$33 billion pursuant to that increase. However, because there was no dedicated fund, it appears that the Postal Service spent most of the money on other matters because it could not control its costs. Mailers are understandably highly skeptical of giving the Postal Service still more funds without a specific purpose and without strong accountability.

1. It is unreasonable to assume that future operating revenue needs are similar those in past years

One fundamental problem with the sums urged by the Postal Service, the APWU, the NALC, and the Public Representative is that they are based on the financial results of carefully selected past years.³¹ As a general matter, they merely assume, generally implicitly, that the Service’s costs would mimic past years with no significant differences, although they hasten to dismiss the most recent year as unrepresentative because its financial results were better than previous years.

³¹ *E.g., USPS Comments at 5 & 58; APWU Comments at 1-7; NALC Comment at 4-5.*

In this vein, the Postal Service submitted in a nonpublic Appendix to its March 1 comments several scenarios drawn from its internal financial forecasts for its net income and liquidity over the next five years. These deserve little credence. Among other things, these scenarios purport to show that in the absence of productivity improvements, with lackluster cost controls, and with stagnant revenue and contribution from Competitive products, the Service's financial position will fail to improve. That should surprise no one, but its assumptions merely illustrate the need for improved cost controls and to take Competitive profits into consideration.

The Postal Service, assuming without explanation that its past results are an appropriate starting point, also urges the Commission to adjust the system for "known factors outside of the Postal Service's control" such as: volume declines, mail mix changes, delivery network growth, and fluctuations in pension/retiree health benefits costs.³² All of these are common business issues routinely faced by private firms, and none justifying exceptions to the cap.

Take, for example, the contention that the expansion of the Postal Service's delivery network imposes fixed costs that the price cap does not allow to be recouped when pieces per delivery point are declining.³³ This is one area in which the Service has made progress in managing costs and the price cap may have worked as intended. In real terms, total annual city carrier street and rural carrier costs declined by \$650 million (in real, inflation-adjusted dollars) from

³² *USPS Comments* at 6 & 70-77.

³³ *Id.* at 52.

2007 to 2017 despite volume declining, delivery points increasing, and carrier costs rising (in nominal terms).³⁴ This indicates that the Postal Service's redesigning of delivery routes has had success in managing costs. This also shows that there is no need for an exogenous adjustment.

Nor should the Commission adjust the price cap because of changes in density or mail mix, as the Service urges. Responding to those changes is a responsibility of postal management. Nothing about a price cap guarantees that customers will continue to purchase the same products in the same proportions. Adding exogenous factors to account for the types of routine changes that affect every business (changes in the mix of products sold, etc.) is a form of cost of service regulation, not a cap.

Most fundamentally, the Postal Service simply is not entitled to the same level of revenue that it enjoyed in any particular past year, and it is certainly not entitled to additional revenue simply so that it can have "retained earnings." It needs only the revenue necessary to enable it, under best practices of honest, efficient, and economical management, to maintain and continue the development of postal services of the kind and quality adapted to the needs of the United States.

³⁴ For the derivation of these values, see Appendix 1 hereto. The OIG similarly found that delivery costs declined because the Postal Service "restructured its delivery operations" in response to falling volume. OIG, *Peeling the Onion* at 12.

2. The Commission cannot determine the Postal Service's operating revenue needs until after taking into account cost reductions and productivity

Although a price cap system is intended to sever the relationship between revenue and cost, that relationship becomes quite relevant when a regulator is considering modifying the cap in order to achieve a new net income target. That process resembles a cost-of-service approach insofar as it sets a required revenue target instead of price levels, and this resemblance is not dissipated by the retention of a price cap structure. The “controllable cost” alternative presented in the appendix to the March 1 comments of the First-Class Business Mailers illustrated that improved net income can be achieved with much lower rate increases if the Postal Service makes a serious effort at reducing costs and improving efficiency (which amounts to the same thing).

Unfortunately, it appears at this time that the Postal Service is unwilling or unable to reduce its costs, notwithstanding its frequent claim that falling volumes and contribution per delivery point give it ample incentive to do so.³⁵ The Postal Service trots out once again a report that it submitted in 2017 purporting to show that, “setting aside potential cost-savings opportunities that are outside management’s control because they require labor, regulatory, and/or political consensus,” the Postal Service could conceivably remove less than \$0.8 billion in

³⁵

USPS Comments at 21.

cost savings, falling far short of the net income “gap.”³⁶ Put differently, the Service’s position appears to be that if nothing changes, it will do no better.

This posturing should not be taken seriously. A \$70 billion organization should have no trouble identifying at least one percent in cost savings annually – which alone would be worth \$700 million. Contrary to the Postal Service’s regulatory pessimism,³⁷ the record identifies numerous opportunities for cost savings or efficiencies going forward that remain entirely within management discretion. Even the 2017 report upon which it relies notes that salary and benefit increases are being driven by higher-than-revenue growth rates in wages.³⁸ It further asserts that the Service could save about \$1.1 billion annually from initiatives under management’s control, and that an additional \$1.6 billion in savings are achievable through “partnership” with the unions and regulator.³⁹

Absent from the Postal Service’s comments is any suggestion that postal management can or will take a firmer position on restraining labor costs in its upcoming negotiations, although a price cap system should cause it to do so.⁴⁰ If market dominant rates were raised simply to pass the resulting proceeds along to

³⁶ *USPS Comments* at 66, citing *Alvarez & Marsal Report*, Docket No. RM2017-3 (filed Mar. 20, 2017). Confusingly, the Postal Service says both that it is being aggressive in reducing costs and that there are few opportunities to do so. Compare *USPS Comments* at 66 with *id.* at 77.

³⁷ To be fair, the First-Class Business Mailers are unaware of any instance in which a regulated entity advised its regulator that it did not need a rate increase because it could reduce costs by a sufficient amount to be profitable. So the Postal Service’s position is unsurprising.

³⁸ *USPS Comments, Appendix C* at 13-14 (Mar. 20, 2017).

³⁹ *Id.* at 20.

⁴⁰ Many postal employees are nearing the end of their careers and are eligible for retirement. The Postal Service should be pushing harder to save money through buy-outs of these senior employees and replacing them with less experienced career employees or casuals.

labor through the collective bargaining/arbitration process, this will not produce financial stability, but only inefficiency and cost increases as mailers pay more to have less mail delivered. And additional aggressive measures are possible; as just one example, Seamless Acceptance should enable the Service to abolish many of the labor intensive position held by senior staff in the mail acceptance functions.

In addition to holding the line on labor costs, other opportunities abound that the Service ignores. A notable example is the Flats Sequencing System. Given that the cost of processing mail on FSS is significantly higher than mail not passing through FSS, several comments noted that “best practices” of management would shut the system down and instead encourage greater presortation of flats, potentially reducing its costs enormously.⁴¹

The Postal Service’s comments also ignore that it could and should do more to reduce costs in many other areas as well. For example, the Integrated Financial Plan anticipates FY 2018 spending of \$15 billion on rents, fuels, and utilities; transportation; and supplies and services. Is it really the case that no savings are possible in this area?⁴² Is it really the case that no postal lessor would be willing to accept slightly lower rents in return for a lease extension, or no supplier would trade a modest price cut for a contract extension?

⁴¹ *SIIA Comments* at 9 (calling FSS a “key contributor” to the unexpected cost increase of Periodicals Mail); *ANM et al. Comments* at 77.

⁴² In 2015, the Postal Service’s OIG suggested that the Postal Service could rein in its rising transportation costs by making more use of rail, as was UPS. OIG, *Peeling the Onion* at 13-14. It appears that the Postal Service reduced its use of air transportation, but it is unclear whether it has made more use of rail. *Annual Compliance Determination Report Fiscal Year 2017* at 116, Table V-8 (Mar. 29, 2018).

For another, were the Postal Service to price worksharing discounts according to Efficient Component Pricing principles, as the *NPRM* has proposed, it might find that it has excess capacity in processing staff. It could also introduce additional worksharing initiatives, and price them efficiently to send the proper signals to mailers. It could resolve the problem of returning to mailers (without being requested) Undeliverable As Addressed Marketing Mail, which incurs considerable cost. It could do far better in managing transportation of mail from First-Class Mailer sites, and quality controls of Mail Transport Equipment.

And the Postal Service could make more creative uses of negotiated service agreements for market dominant products to “anchor” volume and experiment with new cost saving concepts. And it could further push the envelope in its broad-reaching efforts to marry digital technology with processing and delivering the mail.

This is not a comprehensive listing of possible cost reduction measures available to the Postal Service today, but the list illustrates the point. There is much the Service can do to further reduce its costs; but it is easier to ignore the hard work that these might entail, and instead throw up one’s hands in the hope that the Commission will simply give it more money. But that is not what the PAEA requires. That was, in fact, a major driver of the rate cycle in the former cost-of-service system, which the PAEA was intended to break.

Second, despite postal management’s pessimism, no commenter has shown any causal link between the current price cap system and the Postal Service’s failure to react to the incentives established by that system. As ANM *et*

a/. pointed out, no system of rate regulation can force the Postal Service to take serious action to reduce costs or improve efficiency. A system “can only provide the incentives and opportunities to do so; the Postal Service must take advantage of these.”⁴³ Distressingly, the Postal Service seems to have no plan to do so.

Finally, the Postal Service could, applying the best practices of private businesses, look for new revenue sources. Instead, the Postal Service appears to be giving up on its highest margin product – First-Class Presort Mail – and making no real apparent effort to encourage growth. First-Class mailers have approached the Service with several recommendations for leveraging existing business processes to transition more mail into the Full Service automation mail stream instead of the less “profitable” Single-Piece category.⁴⁴

The March 1 comments show that the Commission must first determine how much operating revenue the Service actually needs before attempting to allow the Postal Service to exceed the statutory price cap. That requires taking into account the Service’s reduced volumes compared to 2006, its reduced staff, its redesigned network, and its existing capacity, as well as a clear-eyed assessment of the potential for cost reductions that can improve net income with much smaller rate increases, preserving volume.

⁴³ *Alliance of Nonprofit Mailers, American Catalog Mailers Association, Inc., Association for Postal Commerce, IDEAlliance and MPA-The Association of Magazine Media Comments* at 55.

⁴⁴ For example, mailers have suggested allowing the co-mingling of Single Piece Metered Mail with automation mail, and co-mingling of Marketing and First-Class flats. They have also suggested enabling the use of Value Added Refunds (used today for letters) for First-Class flats.

The Commission should require the Postal Service to submit a real plan that explains the actual, concrete steps that it will take to reduce its costs, manage its network in light of its current size and business, and develop new products and revenue sources to provide the postal services appropriate for the nation.⁴⁵ Only after reviewing such a plan (which should be subject to public comment) and assessing whether currently capped revenue is sufficient can the Commission make a rational decision as to whether the Postal Service has demonstrated a real, defensible need for additional revenue.

C. The Commission Must Determine How Much Capital The Postal Service Really Needs To Be Financially Stable

The Commission's conclusions in Order No. 4257 and the *NPRM*'s proposals regarding the Postal Service's investment capital received substantial attention in the comments. As with the Service's operating revenues, identifying the amount of capital necessary is far more difficult than simply taking the Postal Service's word for it. If the Commission wants to modify the existing rate regulatory system to allow the Postal Service to generate more capital, it first must tackle the challenge of determining how much capital the Postal Service needs for the foreseeable future. This it has not done. Nor, evidently, has the Service.

As background, Order No. 4257 found (at 174) that the Postal Service's capital expenditure ratio had declined from about 4 percent of revenue in 2007 to

⁴⁵ The Commission and mailers are still awaiting a plan to "address systemic and long-standing cost and service issues related to flats processing." *Annual Compliance Determination Report Fiscal Year 2017* at 4 (Mar. 29, 2018).

1 percent in 2013, before rising to 2 percent in 2016. The *NPRM* (at 52) presented a table showing that the book value of the Postal Service's net assets decreased by 33.8 percent from FY 2006 to FY 2016 (we note that volume has fallen by about the same amount over the same period). In an effort to address these purported "deficiencies," the *NPRM* proposed the two "performance-based incentives" that would award bonus cap authority for productivity improvement and maintaining service standards. In setting the size of those incentives, the *NPRM* referred to the amount of the decrease in net asset holdings (\$7.8 billion) and the \$1.2 billion reduction in capital outlays from about \$2.5 billion in FY 2006, the last year under cost-of service regulation, to about \$1.4 billion in FY 2016. *NPRM* at 53.

In our March 1 comments, we showed that the two *NPRM* incentive proposals should be abandoned. We showed that cost reductions were superior to rate increases alone as a means of generating capital for investments, and that any extra pricing authority must be based on actual performance improvements in both productivity and service quality. After reviewing the comments, we have several additional observations.

First, we agree with ANM *et al.* that a lower level of capital investment today under a price cap system than in the last year of cost-of-service regulation is not surprising. Indeed, that is because one goal of price cap regulation is to discourage the regulated entity from padding the rate base with unnecessary capital investments. That capital investment is less is expected, and proves nothing. ANM *et al.* stated accurately: "The Commission does not consider

whether the reduction in capital expenditures during the PAEA era represents a prudent frugality or a forced deprivation.”⁴⁶

Second, several commenters pointed out that the Postal Service is a smaller organization than it was in 2006, handling only two-thirds of the 2006 volume (and falling) with far fewer employees, and that consequently the Commission cannot assume that the level of capital investment at that time is optimal or appropriate for the smaller entity today.⁴⁷ It may well be that the optimal level of capital today “to maintain and continue the development of postal services of the kind and quality adapted to the needs of the nation” using “best practices of honest, efficient, and economical management” is much less (perhaps even half) than that in 2006. Does an organization with a volume of 150 billion pieces (and decreasing) need the same investment as one with 213 billion? The Commission has not made such a determination. Nor has the Postal Service given it a basis upon which to do so.

Third, the record is barren regarding what capital investments the Postal Service truly needs. The *NPRM* identified none, and Order No. 4397 effectively closed the door on any willingness to probe the issue. Although the Postal Service says that it has “starved” (and the NALC says that it has “skimped” on capital in comparison to FedEx and UPS – curiously, rivals to the Postal Service

⁴⁶ *ANM et al. Comments* at 47.

⁴⁷ *E.g., UPS Comments* at 4-5 (Postal Service must right size its capital plant and operations as would a for-profit business in the same circumstances); *PR Comments* at 31 (“there is no demonstration that net asset holdings should be returned to FY 2006 levels . . . Volume has fallen by almost one-third since FY 2006. This suggests that some reduction in assets is appropriate”). *ACMA* (at 3) notes that despite volume declining by one-third, total expenses are “largely unchanged”).

in Competitive products only, not market dominant products),⁴⁸ it does not say what capital investment would be more optimal.

Indeed, the Postal Service's comments identify *no* capital investment that a lack of funds has prevented it from making, referring only vaguely to a need to make unspecified "investments in efficiency, service, and mail security" without offering any specifics.⁴⁹ Nor has the Postal Service presented any evidence of upcoming major new capital initiatives, claiming that the efficiency gains realized with the introduction of automation technology is "non-repeatable" and therefore the past years when its productivity most improved are unrepresentative.⁵⁰ There is absolutely no evidence that more capital would improve delivery. It wants more money, but offers no explanation for what purpose.

Elsewhere, the Service's 2017 10-K Report (at 56) mentions a need for capital to "upgrade its facilities, its existing fleet of vehicles, and its processing equipment." The 10-K is silent, however, regarding the amount of money needed for these purposes, and in fact the Service has been investing in these items for several years.⁵¹ And the Service recently purchased automated package sorting equipment (these presumably will be largely attributed to Competitive products). The Service's 10-K Report shows (at 58) that the net asset value of the Service's

⁴⁸ *NALC Comment* at 7. Of course, the OIG noted in 2015 that "keen differences" between the Postal Service on one hand, and UPS and FedEx on the other, make investment comparisons problematic. OIG, *Peeling the Onion* at 15.

⁴⁹ *E.g., USPS Comments* at 94.

⁵⁰ *Id.* at 99, n.244.

⁵¹ *See Statement of Postmaster General and Chief Operating Officer Megan J. Brennan before the House Oversight and Government Reform Committee*, at 7 (Feb. 7, 2017) (citing investments in delivery vehicles, facilities, and information technology).

vehicles actually increased in 2017. There is no news of big looming investments for letters, and the investment made for FSS has proven, at best, problematic.

There is no record evidence upon which the Commission can determine how much capital the Postal Service needs. It would be arbitrary to rely on past amounts of investment to determine future needs when the entity and the environment in which it operates have changed as much as here, and will continue to change.

It merits noting that in February, the Postal Service's Office of the Inspector General summarized its reviews of Decision Analysis Reports for FY 2017.⁵² The report cited concerns with eight, totaling \$218.8 million. For five DARS, the OIG concluded that the DARS were based on overly optimistic savings projections and nonrealistic achievable results, problems that have afflicted Postal Service initiatives in the past. Six of those eight DARS appear to concern proposals that appear to support Competitive package offerings. While the accrued costs of these investments, if made, might be attributed to Competitive products, the Postal Service in this proceeding implicitly is asking market dominant mailers to finance them upfront.

Nor does the highly hyped decline in the Service's net asset value, without more, justify higher market dominant rates. Commenters that cited the reduced asset sheet ignore that the balance sheet is based on depreciated book value,

⁵² Office of the Inspector General, *Fiscal Year 2017 Decision Analysis Report Summary* (Report Number MI-CAP-18-001) (Feb. 15, 2018). It reviewed 64 DARS totaling \$2.9 billion, about half of which were cancelled before receiving approval by the Postmaster General.

not market value, while the market value of the Postal Service's real estate holdings could be as much as \$85 billion or more.⁵³

This real estate valuation is particularly important, because it is quite feasible for the Postal Service to transform a relatively small portion of its real property assets into investable capital through sales and, where the facility is still needed, leasing back the same facility for some appropriate period of time. The sale would convert the market value of the real estate – which is not shown on the balance sheet according to GAAP – into investable cash, which is shown on the balance sheet. In light of the estimated \$85 billion or more value of the Service's real estate holdings, raising several billion dollars in this manner should hardly present insurmountable problems. Given the ability to reallocate or convert a small portion of its assets base from real estate to other forms of capital, it is reasonable to assume that the Postal Service's reduced investment is due to the lack of projects with good returns on investment rather than a lack of capital.

And, as the ACMA pointed out (at 6, n.2), the Postal Service is unable to quantify the results of its investments today. This is an issue of transparency and accountability. Unless and until the Postal Service can show the value obtained from its billions of dollars in investments (and a willingness to cancel unfruitful

⁵³ *Considerations in Structuring Estimated Liabilities*, Office of the Inspector General, Report Number FT-WP-15-003, at 3 (citing an estimate from June 2012) (Jan. 23, 2015). The Postal Service is inconsistent in its use of GAAP. It opposes the use of GAAP when it argues that the workers' compensation adjustment of \$2.2 billion in FY 2017 should be ignored, but insists on GAAP for valuing its real estate. See *USPS Comments* at 59 & n.154.

ones), the Commission will have no way to monitor the Postal Service's progress on capital other than the gross measure of the amount spent.

Lastly, the Postal Service and others criticize the *NPRM* for placing the cart before the horse, saying that the Service cannot undertake the investment necessary to earn incentive bonus authority (as proposed in the *NPRM*) without additional capital upfront.⁵⁴ But the Postal Service had more than \$10 billion in cash reserves on hand at FY 2017 year-end⁵⁵ -- nearly seven times the amount of capital invested in FY 2016 -- and could make significant investments to start the "harmonious cycle" without even an extra penny.

The record does not establish the need for any particular amount of additional capital, or how market dominant mailers would benefit from any investments that the capital might fund. That burden rests on the Service, and it has failed to meet it. That failure leaves the Commission with no basis for determining how much, if any, additional capital the Postal Service needs going forward, and therefore with no rational basis for approving any above-cap modifications designed to increase capital.

D. The Commission Must Determine How Much, If Any, Additional Revenue The Postal Service Really Needs From Market Dominant Products To Be Financially Stable

After the Commission has determined how much operating revenue and investment capital the Postal Service needs today and in the next five to ten years, it is only part of the way to a solution. It next must determine how much of

⁵⁴ See *USPS Comments* at 6; *APWU Comments* at 15.

⁵⁵ *USPS Fiscal Year 2018 Integrated Financial Plan* at 4.

that money should be extracted from mailers subject to market dominant rate regulation and to what degree the Postal Service should look to Competitive products for that money.

The Postal Service and its unions' comments implicitly assume no further increase in Competitive product revenue, as did the *NPRM*. For example, the National Association of Letter Carriers urged the Commission to adopt an immediate 10 percent "true-up" of *market dominant* rates while ignoring any revenue from Competitive products.⁵⁶ The Postal Service devoted many pages of its comments to recalculating the amount by which it wants the Commission to allow it to raise rates to make it "whole," but nowhere acknowledged that it receives substantial sums from Competitive products today and expects increasing sums in the years to come.

Nothing in the law requires that deficits shortfalls must be extracted from market dominant mailers alone.⁵⁷ It is indisputable that the revenue and contribution the Postal Service obtains from Competitive products count in its overall financial position, and Congress specifically requires Competitive products to contribute at least an appropriate share of institutional costs.⁵⁸

⁵⁶ *NALC Comment* at 4 (Feb. 28, 2018); see also *American Postal Workers Union Comments* at 13 (urging Commission to raise market dominant rates to cover the average annual loss of \$6.2 billion during the PAEA).

⁵⁷ *GCA Comments* at 3-4; *ANM et al. Comments* at 71-74. The statute does not set a minimum share requirement for market dominant products at all.

⁵⁸ 39 U.S.C. §3633(b). The Commission recently proposed a system that would increase that minimum. *Notice of Proposed Rulemaking To Evaluate the Institutional Cost Contribution Requirement for Competitive Products*, Docket No. RM2017-1 (Feb. 8, 2018) (Order No. 4402).

Today, Competitive products provide 30 percent of the Postal Service's revenue. In FY 2017 alone their revenue exceeded total costs by about \$7 billion, or 23 percent of institutional costs. *United States Postal Service FY 2017 Annual Compliance Report* at 73. That amount was \$1.5 billion more contribution than from Marketing Mail and Package Services combined. Accordingly, our March 1 comments explained that as a matter of both law and policy, the Commission should reduce any amount that it finds the Postal Service needs by at least 30 percent.

And any assumption that Competitive revenues will not increase in the years to come is unreasonable. Indeed, from FY 2016 to FY 2017, revenues from Competitive products increased by \$2.2 billion, offsetting most of the \$3.1 billion decline in revenue from market-dominant products.

Going forward, several commenters suggested that Competitive products alone could cover the entire net income shortfall in the coming years, consistent with the changes from FY 2016 to FY 2017 noted above. But as discussed in the next section, there is no assurance that this would remain the case if the Commission provides the additional rate authority proposed in the NPRM, because such increases could accelerate the market dominant volume losses.

The Commission must take the expected increase in Competitive product revenues into account, as they are an integral part of the Postal Service's overall financial condition.

E. The Commission Must Consider The Permanent Harm To Market Dominant Volume If Rates Were Raised Above CPI-U

After determining: (1) how much operating income the Postal Service needs; (2) how much capital it needs for investment; and (3) how much of those monies should be obtained from market dominant mailers, the Commission still must assess how much market dominant rates could be raised above inflation without driving away a perilous amount of volume.

While important, financial stability is but one of nine objectives that are to be considered in conjunction with one another. Contrary to the urgings of the APWU (at 3), Objective 5 is not “paramount.” Other objectives, including the maximization of incentives for cost reduction and efficiencies, for stable rates, and for just rates, are equally vital and must be considered “in conjunction with” Objective 5, while taking into account Factors 3, 4, 5, 7, 10, and 12, when contemplating above-cap rate increases.

Several parties point out that the Postal Service’s current volume forecasting models are of little to no use in estimating volume changes as a result of rate increases in the range proposed by the *NPRM* or higher. The Public Representative correctly points out that the *NPRM*’s “constant elasticity assumption is unsupported when used for volume levels substantially outside the range of actual experience.”⁵⁹ He errs, however, in suggesting that this would require even higher rates.

The First-Class Business Mailers concur with the Public Representative that the Postal Service’s elasticity figures have little value, because real postage

⁵⁹

PR Comments at 26, n.25.

rates have hardly moved in past decade. A decade's worth of experience with almost zero change in real price (due to the CPI cap) provides no basis for assessing the effects of rate increases of two, six, or ten percent more than inflation. Forecasting from models fit from input variables well below the values those variables will take in the future produces estimates having very uncertain accuracy. Also, the Postal Service's models look backwards, in the sense that they are retrofit each year in order to "forecast" the volume that, by the time of the retrofitting, is known, and are less accurate when looking ahead because the fitting cannot anticipate changes in trends or even the effect of price increases outside of those used in fitting the model. Even the current model required further tinkering in the most recent iteration to adjust to the more rapid volume losses currently being experienced.

The NALC argued that the exigency surcharge had only "modest effects on mail volume."⁶⁰ That misreads the lessons to be learned from the exigency surcharge, and displays a distressing lack of understanding of how business mailers adjust volumes and budgets in the face of rate changes.

First, the exigency surcharge was in effect for a limited time with an expected expiration (despite being extended). Some mail did leave immediately in response, and other mail left over a longer period. Mailers knew that it was intended to be temporary. A permanent, non-rescindable rate increase would have a larger impact on volumes.

⁶⁰ See *NALC Comment* at 21.

Second, the NALC's timeframe is too limited. Business mailers – at least those in First-Class – respond fairly slowly to rate changes, but once made, adjustments to mailing budgets and volumes become permanent. That process can take more than one budget cycle. Contrary to those citing the exigency surcharge as evidence that higher rates have little effect on volumes, the true long-term effect of the surcharge is appearing now and contributing substantially to the current, post-exigency accelerated declines in First-Class volume.

These trends continue. The comments of one mailing services provider could speak for all business mailers:

These proposed increases have already encouraged [our customers] to consider reducing volume by targeting and accelerating their migration to digital channels and alternate delivery methods. In the last six months, we have seen a decrease in large volume direct mail among our customers by more than 30%, and our statement and transactional mail volume continues to decline as much as 10% each year. Our clients expect to continue to reduce volumes in print and mail as the cost for postage increases.

A.B. Data, Ltd. Comments at 1. This is the real world impact of the proposals in the *NPRM*. Once these businesses make the investments to use alternative channels, they will not come back to the mail. Allowing the Postal Service to raise rates above the CPI-U cap could only accelerate these trends more.

Appended to the First-Class Business Mailers' March 1 comments was an analysis showing that, with sustained cost reductions, the Postal Service could achieve net income and net balance sheet improvements at much smaller market dominant rate increases than proposed by the *NPRM*. To respond to the

comments ignoring Competitive product revenue and market dominant price elasticity, an updated version of that analysis is attached (Appendix 2 hereto). The updated version is adjusted to account for both estimated Competitive product contribution and market dominant price elasticity. It concludes:

With these two adjustments, the revised model still illustrates the benefits of providing incentives for cost control and efficiency growth in the context of addressing the Service's long-term financial stability. However, the revised model demonstrates two further points. First, the Service's financial condition is considerably less dire than is suggested by the parties who have focused solely on market dominant products alone. . . . Second, the short-sighted disregard of the demand effects of proposing substantial and continuing above-inflation price increases for market dominant products could itself cause further financial deterioration of the kind the PRC is trying to prevent

Appendix 2 at 1-2. For example, using the recently estimated average price elasticity for market dominant mail of -0.42 and assuming rates for Competitive products increase by CPI + 2 percent in each of the next five years – both eminently reasonable assumptions -- the Controllable cost model results in lower operating costs, substantially more improvement in the net balance sheet, higher volume, and lower market dominant rates compared to the *NPRM's* approach.

We recognize that the controllable cost model has some inconsistency with the regulatory theory of price caps, but the Commission has already found that the current system has proved insufficient in causing the Postal Service to take necessary cost reduction measures. More is needed. The controllable cost model suggests that the Postal Service and mailers would be better off with a combination of smaller rate increases than proposed by the *NPRM* and serious cost reductions coupled with better management of its assets by the Postal

Service. Under these circumstances, a departure from price cap theory is far preferable to the higher rates proposed by the *NPRM*.

V. THE WORKSHARE PROPOSAL SHOULD BE ADOPTED WITH THE MODIFICATIONS PREVIOUSLY OFFERED IN OUR MARCH 1 COMMENTS

Comparatively few parties addressed the *NPRM*'s proposal to require greater use of Efficient Component Pricing in worksharing discounts.

Worksharing is a major cost reduction option available to the Postal Service, despite its claims to have exhausted its ability to shed costs, and the *NPRM* proposal should be adopted, with the modifications proposed in our March 1 comments.

The Greeting Card Association and the Postal Service, while supporting ECP in concept, request greater clarity as to the role of the Section 3622(e) statutory exceptions.⁶¹ It is our understanding that the exceptions would remain available to the Postal Service for discount pass-throughs that exceed the presumptively allowed band. However, we agree that the Commission should clarify this point.

GCA also questions how discounts in a multi-tier category such as First-Class Presort Mail are to be calculated. It is concerned with how discounts further down a tier would be set when taken from a rate that, itself, reflects a pass-through of more than 100 percent.⁶² For accurate and efficient pricing

⁶¹ GCA Comments at 20. See also USPS Comments at 147 (urging retention of the exceptions and limitations in Section 3622(e)(2)-(3) to justify outside-band pass-throughs on a case-by-case basis).

⁶² GCA Comments at 21-22.

policy, the correct marginal pass-through should be 100 percent, regardless of how the rate from which the discount is taken was set. This provides the correct pricing signal to a mailer that incentivizes efficient behavior. As a practical matter, the First-Class Business Mailers' proposal to narrow the presumptive bands in First-Class Mail to a range from 95 to 105 percent pass-throughs should address this concern.⁶³

The Postal Service requests that the bands be expanded in cases where the cost avoidance is so small that any deviation from 100 percent pass-through would fall outside the compliance bands. In particular, it asks the Commission to allow "a limited range of compliant price points (at least the cost avoidance +/- \$0.001)."⁶⁴ We see no real need for an exception to ECP for cost avoidances of \$0.001.

The Postal Service also requests that proposed Rule 3010.262(a) be changed so that the grace period starts with the implementation date of the first general price change after the effective date of the new rules."⁶⁵ The First-Class Business Mailers oppose any grace period, much less a longer one. Delaying full implementation of ECP will harm efficiency throughout the so-called "grace period." We agree, however, that the Postal Service should be able to ask to invoke one of the statutory exceptions if applicable.

⁶³ See *First-Class Business Mailers Comments* at 42-43; accord *Pitney Bowes Comments* at 10-11.

⁶⁴ *USPS Comments* at 147.

⁶⁵ *Id.*

The ECP proposal remains fully consistent with Objective 1 (cost reduction), Objective 5 (financial stability), and Objective 8 (reasonable rates) and should be adopted.

VI. THERE IS WIDESPREAD AGREEMENT THAT TOTAL FACTOR PRODUCTIVITY IS A POOR METRIC AND SHOULD NOT PROVIDE THE BASIS FOR A PERFORMANCE INCENTIVE

No aspect of the *NPRM* received more criticism than the proposal to award 0.75 percent in extra cap authority for improving Total Factor Productivity. The Commission should abandon this proposal. Nothing other than an approach that focuses on reducing controllable costs should be considered.

The criticisms of the TFP approach proposed by the *NPRM* came from all sectors – mailers, unions, and the Postal Service. The TFP proposal was criticized for being too difficult to meet⁶⁶ and too easy to meet.⁶⁷ It was criticized as a metric inappropriate for the proposed usage, one too susceptible to Postal Service manipulation, and as too likely to change in non-intuitive directions.⁶⁸

The First-Class Business Mailers share these concerns, although we did suggest that TFP could serve as an interim measure if necessary while a superior metric – controllable costs – could be developed and added to the Commission’s regulations. These criticisms, however, should not deflect the Commission from the important consideration, which is that absent

⁶⁶ See *USPS Comments* at 96-108; *APWU Comments* at 15-16;

⁶⁷ *ANM et al. Comments* at 57.

⁶⁸ *USPS Comments* at 86; *UPS Comments* at 6 (stating that the Postal Service could manipulate TFP without improving the market dominant business, thus benefitting only Competitive products); *Netflix Comments* at 22 (TFP is impractical within a five year period).

improvements in productivity (which include cost reductions and other cost savings), the Postal Service would face an unpromising future.

It is unsurprising that the Postal Service and its employees resist any effort to condition rates on productivity improvements. However, placing the entire burden on mailers would be doomed to fail as well. Although the Commission would be well advised to retreat from its TFP proposal, it should carefully consider alternative approaches based on controllable costs. Indeed, insofar as the Postal Service complains (at 100) that TFP could “punish” it for factors beyond its control, the Controllable costs approach rectifies that problem.

VII. THE SERVICE STANDARD PROPOSAL MUST BE BASED ON ACTUAL SERVICE PERFORMANCE, NOT MERELY STANDARDS

There is little to add to our March 1 comment on this proposal. Numerous commenters pointed out the uselessness of basing extra cap authority on retention of published standards instead of actual performance.

The APWU, however, argues (10) that higher prices are necessary to have better service. This is neither intuitive nor fact-based. There is no evidence on the record that higher prices lead to better service. Instead, higher prices tend to get absorbed into higher wages, which have risen throughout the PAEA period while service has declined.

The Public Representative criticizes the proposed 0.25 percent extra rate authority as too low to have material actual influence on postal management decisions, saying that any cost savings from a further reduction in service standards would likely far exceed the incentive bonus that would be sacrificed for

the change. That criticism may have merit. The solution, however, is not to make the bonus larger but to refocus the incentive on actual service performance.

VIII. MANY OF THE OTHER SUGGESTIONS IN THE COMMENTS ARE BEYOND THE SCOPE OF THE *NPRM*

The comments contain a number of suggestions that are, regardless of their merits, outside the scope of this proceeding as defined by the *NPRM*. These include such ideas as the NALC's request (at 5) that the Commission redefine the term "extraordinary or exceptional circumstances" to some term that would be much easier for the Postal Service to meet, such as "changing market conditions" – a term that could mean anything. Nothing in the *NPRM*, however, puts interested persons on notice that the Commission might entertain amending its interpretation of the exigency provision.

Other suggestions having more merit nonetheless suffer the same defect. These include the Postal Service's request (at 158-159) that the Commission modify how negotiated services agreements are reflected in the billing determinants, although the First-Class Business Mailers are sympathetic to that change. Although we agree that the Postal Service should be making far greater use of NSAs with large mailers to anchor volumes and smooth staffing decisions, unfortunately this idea was not included in the *NPRM* and therefore cannot be considered further at this time.

Also outside the scope of this proceeding is the Postal Service's request (at 161-162) to eliminate the Section 3622(d)(2)(A) provision that locks the price cap to the Domestic Mail Classification Schedule as it stood on the date of the

PAEA's enactment. The First-Class Business Mailers take no position on this idea at this time, but this would require a new notice of proposed rulemaking.

Finally, the NALC asks the Commission to replace the CPI-U with the CPI-DS (which would allow much greater rate increases) on the grounds that it would "require the Postal Service to seek to match the efficiencies of private-sector delivery companies."⁶⁹ This is barred both because Congress specified the CPI-U, and because the *NPRM* gives no notice that an alternative index might be adopted. Although it is interesting that NALC recognizes that FedEx and UPS are more efficient than the Postal Service (meaning the Service has plenty of room to improve), we note that those companies compete with Competitive products. Is the NALC suggesting that market dominant rates should be raised above CPI-U in order to subsidize Postal Service efforts to improve efficiency in package services?

We, too, offered suggestions for improving the system in our March 20, 2017, comments that did not find their way into the *NPRM*. But unless replaced by a new notice, the *NPRM* now limits the scope of this proceeding.

IX. IF THE COMMISSION CONTINUES TO BELIEVE IT HAS LEGAL AUTHORITY TO ACT, IT SHOULD ISSUE A REVISED NOTICE OF PROPOSED RULEMAKING

There is no need to rush. The Postal Service continues to have ample cash on hand, because its defaults on the various retiree payments have no real-world consequence. We concur with ANM *et al.* It is more important to take the

⁶⁹

NALC Comment at 23.

time to do this review properly than it is to rush more money from the pockets of mailers into the hands of the Postal Service.⁷⁰

The SIIA suggests that the Commission delay the effective date of any changes it may make for at least 18 months to allow Congress time to act.⁷¹ While we agree that there is no urgency for new rules to take effect given the Postal Service's strong cash position and lack of consequences for its defaults, the Commission could use that time more usefully by conducting this review properly.

The Commission should take a deep breath and rethink its approach. A proper conclusion requires a reassessment of the limited legal authority actually conferred on this Commission by Section 3622(d)(3), and a thoughtful reconsideration of the amount of operating funds and capital that the Postal Service actually needs to "maintain and develop" postal services for the United States.

Even once that is done, however, the Commission must still give further consideration to how much of any remaining increase must be borne by the declining market dominant part of the business, and how much by the growing Competitive side. And of the former, it must reconcile the need for whatever sum is remaining with its obligation to protect, not exploit, mailers of market dominant products from high rates, and to avoid driving even more volume out of the system at a further accelerated rate.

⁷⁰ *ANM et al. Comments* at 99-101.

⁷¹ *SIIA Comments* at 13.

These steps may very well require a new notice of proposed rulemaking. They certainly require more time.

X. CONCLUSION

For the foregoing reasons, the First-Class Business Mailers respectfully urge the Commission to give full consideration to these reply comments, and to our comments filed on March 1, 2018.

Respectfully submitted,

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Appendix 1: Carrier Costs

		Rural Carrier & City Carrier Street Time (Nominal)	Inflator to FY 2017	Rural Carrier & City Carrier Street Time (Real)	Total Mail Volume	Delivery Points
		[a]	[b]	[c]	[d]	[e]
FY 2007	[1]	\$17,450,346	1.19	\$20,722,440	212,234,469	147,992,522
FY 2017	[2]	\$20,085,294	1.00	\$20,085,294	149,490,633	157,328,676
Change	[3]	\$2,634,948		- \$637,146	-29.6%	6.3%

[1][a] Docket No. ACR2007, USPS-FY07-2, FY07.Seg&CompRpt.xls, "CSSummary", cell H47 + J47

[2][a] Docket No. ACR2017, USPS-FY17-2, FY17Public Cost Segs and Comps.xlsx, "CSSummary", cell G61 + I61

[3][a] = [2][a] – [1][a]

[b] bls.gov

[1][c]:[2][c] = [a] * [b]

[3][c] = [2][c] – [1][c]

[1][d] Docket No. ACR2007, USPS-FY07-1, fy07cra.rev.3.20.08.xls, "VolStats"

[2][d] Docket No. ACR2017, USPS-FY17-1, Public_FY17CRAReport.xlsx, "Volume1" & "Volume2"

[3][d] = [2][d] / [1][d] – 1

[1][e] 2011 Annual Report to Congress and Comprehensive Statement on Postal Operations, p. 23

[2][e] United States Postal Service FY2017 Annual Report to Congress, p. 9

[3][e] = [2][e] / [1][e] – 1

Appendix 2: Updated Technical Appendix

The initial comments by the First-Class Business Mailers included a technical appendix with a simplified model of Postal Service finances that was designed to illustrate a single point concerning the importance of linking any above-CPI increases to demonstrated improvements in the Service's cost and efficiency. Our argument was that cost control and efficiency growth are essential to long-term financial stability and that any approach seeking to improve the Service's financial stability using price increases alone will be far less successful. To demonstrate this point in a transparent way, the model we developed simplified other aspects of the Service's finances.

In reviewing the comments filed by other parties, it is clear that many of them are missing two key aspects of the Service's finances that directly affect its long-term financial stability:

- The steady increase in competitive product volume and prices has substantially increased revenue and contribution from competitive products, year after year. For example, from FY 2016 to FY 2017, revenues from competitive products increased by \$2.2 billion, offsetting most of the \$3.1 billion revenue decline from market dominant products.
- The fragile state of demand for market dominant products raises the distinct possibility that substantial increases in prices above inflation could dramatically accelerate the long-term decline in volume. In a market where demand has fallen at an average annual rate of 2.4% since FY 2009 – not including the drop of 12.6% from the financial crisis that occurred between FY 2008 and FY 2009 – it is necessary to seriously consider the possibility that a new financial shock from excess postal increases could cause substantial additional declines in volume and further worsen the long-term trend.

This appendix presents a revised model that addresses these two key points. First, the revised model describes revenue and cost changes separately for market dominant and competitive products in order to illustrate the substantial beneficial effects from increasing competitive volume and prices. Second, the revised model includes a price elasticity parameter to adjust the volume for market dominant mail to reflect further reductions that will result from price increases above inflation.

With these two adjustments, the revised model still illustrates the benefits of providing incentives for cost control and efficiency growth to address the Service's long-term financial stability. However, the revised model demonstrates two further points. First, the Service's financial condition is considerably less dire than is suggested by the parties who have focused solely on market dominant products alone. In this context, the PRC's proposal to provide an increase of 3 percentage points above inflation over multiple years is clearly excessive – a proposal apparently driven by the PRC's seemingly innocuous assumption that contribution from competitive products will remain constant, an assumption flatly contradicted by the

historical record showing substantial increases in competitive contribution over time.¹ Second, the short-sighted disregard of the demand effects of proposing substantial and continuing above-inflation price increases for market dominant products could itself cause further financial deterioration of the kind the PRC is trying to prevent.

Detailed Spreadsheet Description

This section describes the changes that have been made to the spreadsheet to reflect the two complexities that have been added to the model.

The revised model calculates revenues, costs and volumes separately for market dominant and competitive products. The starting point for the figures uses FY 2018 values that are projected forward from FY 2017 values from the USPS Cost and Revenue Analysis as well as the FY 2018 Integrated Financial Plan, using the model's parameter assumptions for volume change for market dominant and competitive products, as well as annual input price inflation, TFP growth without incentives and adjusted competitive price increases above inflation. For costs, the volume variable costs for market dominant and competitive products are adjusted separately, in addition to the third category of "other" costs, which primarily encompass institutional costs and are assumed not to be affected by volume changes.²

For the volume projection, the revised model uses annual estimates of a decline of 3.5% for market dominant products and an increase of 7% for competitive products in place of the combined value used in the original model of a total annual decline of 3.0%. When combined, the two separate figures for market dominant and competitive products produce a total volume decline roughly equal to that of the original model. The parameter estimates were derived from the projected volume changes between FY 2017 and FY 2018 in the FY 2018 Integrated Financial Plan. For market dominant mail, the parameter value of 3.5% was calculated as the weighted average volume change across First-Class Mail, Marketing Mail and Periodicals. For competitive mail, the projected volume change for Shipping and Packages was used. In years 4 and 5 of the model, the growth of competitive products is moderated to 5% to reflect the possibility that current trends may slow.

The projected annual volume decline for market dominant products also includes the effect of a price elasticity parameter that produces further decreases in volume if real prices rose in the previous year. The effect of this price elasticity is added on top of the annual 3.5% decline. The

¹ RM2017-3, PRC Order No. 4258, Notice of Proposed Rulemaking for the System for Regulating Rates and Classes for Market Dominant Products at 41 n.58. RM2017-3, Comments of Alliance of Nonprofit Mailers, American Catalog Mailers Association, Inc., Association for Postal Commerce, Idealliance and MPA—The Association of Magazine Media at 72, Figure 6.

² This model ignores the annual payments related to amortized retiree benefits, consistent with USPS practice of defaulting on these obligations.

price elasticity in the baseline model is -0.42, a weighted average of the long-run own-price elasticity estimates from the most recent demand equations for eight major market dominant products, using FY 2017 volumes as the weights.³

The baseline model also includes a parameter for competitive product price increases above inflation. However, to implicitly adjust for mail mix changes in competitive products, we base the parameter estimate on the change in revenues per piece for Shipping and Packages from FY 2017 to FY 2018 in the FY 2018 Integrated Financial Plan. This projected increase is 2.5% per piece, compared to a weighted average increase of 0.5% per piece for First-Class Mail, Marketing Mail and Periodicals. We use the 2.0 percentage point difference between these two values as the parameter value for the size of the per piece increase of competitive products above inflation. As a result, our choice for this parameter value reflects an implicit adjustment for changes in mail mix in the context of our simplified model.

The two parameters related to competitive products – annual volume increases of 7% (moderating to 5%) and real price increases of 2% – imply annual real revenue increases of 9% for years 1-3 of the model, moderating to 7% for years 4-5. These projected revenue increases in the model are *lower* than the increases that have been achieved for competitive products in the recent past. For the 5-year period from FY 2012 to FY 2017, real revenues for competitive products increased at an average annual rate of 11.4%. For the 10-year period from FY 2007 to FY 2017 real revenues for competitive products increased at an average annual rate of 8.3%, even with the effects of the 2008 financial crisis.⁴

The other baseline parameter assumptions are the same as those in the original model. Annual input price inflation above CPI is assumed to be 0.5%, based on the difference between the Employee Cost Index and the CPI over the past decade. Baseline TFP growth is assumed to be 0.6%, consistent with the 5-year average from FY 2012 to FY 2016.

³ The eight products are First-Class Single-Piece Letters, First-Class Workshared Letters, Marketing Mail Commercial Letters, Marketing Mail Commercial Flats, Marketing Mail Commercial ECR Basic, Marketing Mail Commercial High Density and Saturation Letters, Commercial High Density and Saturation Flats, and Periodical Regular Mail. Together, these products represents 94.6% of market dominant volume. Price elasticity estimates from Econometric Demand Equation Tables for Market Dominant Products as of January, 2018, Prepared for the Postal Regulatory Commission.

⁴ Calculated from the annual competitive product revenue increases shown in the Revenue, Pieces, and Weight filings for FY 2008 through FY 2017: 6.4%, -3.0%, 5.2%, 6.3%, 24.0%, 19.5%, 10.9%, 9.4%, 12.9% and 12.0%. Adjusted for inflation using the CPI-U from <https://www.bls.gov/cpi/tables/supplemental-files/historical-cpi-u-201802.pdf>.

Four Scenarios to Evaluate Different Approaches to Achieving USPS Financial Stability

This section describes the results of four scenarios to consider different approaches to achieving USPS financial stability. As with the original model, the revised model illustrates the fundamental point that it is possible to produce similar improvement in the balance sheet as the NPRM proposals with smaller price increases if there are incentives for cost reduction. The revised model also illustrates that USPS finances are essentially currently stable, when taking into account that revenue and contribution growth from competitive products offsets the revenue and contribution decline from market dominant products. In addition, the different scenarios illustrate that the NPRM proposals could substantially undermine USPS financial stability by accelerating the decline in market dominant volume.

Scenario 1: No Change

Table 1a shows the results of allowing historical trends to continue over the next 5 years with no change to the price cap. The results are produced by altering the parameter assumptions in our models so there are no price increases above CPI for market dominant products.

Table 1a: No Change with Historical Values

Above-CPI Price Increases	Net Balance Sheet Improvement Over 5 Years	Real Price Increase Over 5 Years	Projected Market Dominant Volume in 2023
Not allowed	-\$1.0 billion	0.0%	116.6 billion

Source: Reply Rate and Cost Changes.xlsx, Scenario 1a – No Change

The No Change Scenario 1a in Table 1a indicates that USPS finances are essentially stable over the next 5 years, with projected increases in revenues and contribution from competitive products compensating for projected decreases in revenues and contribution from market dominant products. Over the 5-year period, revenues from competitive products would increase by \$11.1 billion while those from market dominant products would decrease by \$7.5 billion. At the same time, contribution from competitive products would increase by \$6.2 billion while those from market dominant products would decrease by \$3.1 billion. The net increase in contribution of \$3.1 billion would move the annual operating income from a small deficit to a small surplus.

Of course, the scenario in Table 1a depends in part on continued increases in revenues and contribution from competitive products over the next 5 years, consistent with the strong historical increases seen in the recent past. Both the PRC and USPS have assumed, implausibly, that the strong growth in competitive volumes and real prices seen in the recent past will simply

stop.⁵ This ahistorical assumption is one of the key steps used to create a misleading argument that tries to demonstrate that the Service's financials are not stable. Table 1b illustrates the results of the simple model when real competitive revenues are assumed to be constant, with both fixed competitive volume and fixed real prices.

Table 1b: No Change with Fixed Competitive Revenues

Above-CPI Price Increases	Net Balance Sheet Improvement Over 5 Years	Real Price Increase Over 5 Years	Projected Market Dominant Volume in 2023
Not allowed	-\$24.6 billion	0.0%	116.6 billion

Source: Reply Rate and Cost Changes.xlsx, Scenario 1b – Fixed Comp Rev

Scenario 1b in Table 1b demonstrates the point that the Service's current financial stability depends in large part on the substantial growth in revenues and contribution from competitive products. If this growth is assumed away, the Service's financial condition looks bad. However, that negative conclusion is simply the result of an implausible assumption about the trends in the revenues and contribution of competitive products.

Scenario 1a also depends in part on the assumption that TFP growth will continue at historical levels. If, instead, the Service abandons ordinary efforts to improve productivity, this will also have a substantial effect on the Service's projected financial stability. Table 1c illustrates the results of the simple model when TFP growth is assumed to be zero.

Table 1c: No Change with Fixed TFP

Above-CPI Price Increases	Net Balance Sheet Improvement Over 5 Years	Real Price Increase Over 5 Years	Projected Market Dominant Volume in 2023
Not allowed	-\$10.0 billion	0.0%	116.6 billion

Source: Reply Rate and Cost Changes.xlsx, Scenario 1c – Fixed TFP

If, contrary to the historical experience, competitive product revenues and TFP are both fixed, the combined effects of Tables 1b and 1c illustrate that it is easy to create a simple model that produces results showing the Service's balance sheet worsening by over \$30 billion in the next 5 years. This is shown in Table 1d. Again, this result does not indicate that the Service's finances are unstable; rather, the results indicate only that incorrect parameter assumptions will produce misleading results.

⁵ RM2017-3, PRC Order No. 4258, Notice of Proposed Rulemaking for the System for Regulating Rates and Classes for Market Dominant Products at 41 n.58.

Table 1d: No Change with Fixed Competitive Revenues and Fixed TFP

Above-CPI Price Increases	Net Balance Sheet Improvement Over 5 Years	Real Price Increase Over 5 Years	Projected Market Dominant Volume in 2023
Not allowed	-\$32.1 billion	0.0%	116.6 billion

Source: Reply Rate and Cost Changes.xlsx, Scenario 1d – Fixed Comp Rev & TFP

Scenario 2: March 1 Comments Baseline Model

Scenario 2 shows the results for the baseline parameter values that we used in our initial comments filed on March 1. The NPRM proposals assume a 2% increase above inflation each year and an additional 0.75% increase for meeting the target for TFP growth. The controllable cost alternative links all above-CPI price increases to reductions in controllable costs that can occur either through additional TFP growth or reductions in input price inflation. The baseline version of the original model assumed that this price incentive produced additional TFP growth of 1.0 percentage points and a change in input price inflation of -1.0 percentage points. The price incentive of the rule allowed an above-CPI increase that equaled 50% of the total cost savings produced from the additional TFP growth and the reduction in input price inflation. The TFP alternative links all above-CPI price increases to reductions in controllable costs that occur through additional TFP growth alone. The baseline version of the original model assumed that this price incentive produced additional TFP growth of 1.0 percentage points and that the price incentive allowed an above-CPI increase that equaled 50% of the total cost savings produced.

Table 2 shows the results for the three rules in the revised model using the previous baseline parameter values.

Table 2: March 1 Baseline Model Parameters

Above-CPI Price Increases	Net Balance Sheet Improvement Over 5 Years	Real Price Increase Over 5 Years	Projected Market Dominant Volume in 2023
NPRM Proposals	\$13.8 billion	14.5%	111.1 billion
Controllable Cost Alternative	\$25.0 billion	5.3%	114.5 billion
TFP Alternative	\$12.3 billion	2.6%	115.6 billion

Source: Reply Rate and Cost Changes.xlsx, Scenario 2 – March 1 Baseline

The results shown in Table 2 underline the basic conclusion from our initial comments about the beneficial effects of linking any above-CPI price increases to improvements in cost and efficiency. In addition, however, the revised versions of the models show substantially higher net balance sheet improvements for the two alternatives, with essentially no change for the NPRM proposals. (For comparison, Table 1 in our initial comments reported balance sheet improvements of \$14.8 billion, \$16.7 billion and \$2.6 billion, respectively, for the NPRM proposals, the controllable cost alternative and the TFP alternative.) In the revised model, all three models benefit from extra contributions coming from competitive products over the next 5 years. However, the NPRM proposals also reduce market dominant mail volume by 5.5 billion because of their substantial increase in prices above inflation, which in turn wipes out some of the balance sheet improvements coming from considering the effect of competitive products. The alternatives also reduce market dominant volume, but their volume reductions are much smaller because their real price increases are much smaller.

Scenario 3: Higher Demand Elasticity for Market Dominant Products

The USPS demand equations for market dominant products have been estimated using data for the past 6-18 years (depending on the product), a period when real price movements have been quite small. As a result, the estimated parameter values for the price elasticity of demand may not accurately estimate the demand response to much larger real price increases. Given the extended period of volume declines that have been experienced by market dominant products, it is important to consider the overall fragility of market dominant demand and the possibility that true price elasticities are substantially larger than those estimated by USPS with available data. Scenario 3 looks at the implications of price elasticities of -0.7 or -1.0, rather than the -0.42 used in the baseline model. These results are provided in Tables 3a and 3b, respectively, with all other parameters being set at their baseline values.

Table 3a: Price Elasticity of -0.7 for Market Dominant Products

Above-CPI Price Increases	Net Balance Sheet Improvement Over 5 Years	Real Price Increase Over 5 Years	Projected Market Dominant Volume in 2023
NPRM Proposals	\$12.1 billion	14.5%	107.6 billion
Controllable Cost Alternative	\$24.4 billion	5.3%	113.1 billion
TFP Alternative	\$12.0 billion	2.6%	114.9 billion

Source: Reply Rate and Cost Changes.xlsx, Scenario 3a – Elasticity -0.7

Table 3b: Price Elasticity of -1.0 for Market Dominant Products

Above-CPI Price Increases	Net Balance Sheet Improvement Over 5 Years	Real Price Increase Over 5 Years	Projected Market Dominant Volume in 2023
NPRM Proposals	\$10.3 billion	14.5%	103.9 billion
Controllable Cost Alternative	\$23.8 billion	5.3%	111.6 billion
TFP Alternative	\$11.7 billion	2.6%	114.1 billion

Source: Reply Rate and Cost Changes.xlsx, Scenario 3b – Elasticity -1.0

Tables 3a and 3b show that the NPRM proposals could result in substantial further decreases of market dominant mail volume if the demand elasticity in response to meaningful price increases is larger than suggested by USPS estimates with available data. When the price elasticity parameter is set at -0.7, the NPRM proposals result in a reduction of market dominant mail volume to 107.6 billion, compared to the projection of 116.6 billion in the Doing Nothing Scenario 1a shown in Table 1a. This is a further reduction of 9.0 billion (7.7%) from Scenario 1a. When the price elasticity parameter is set at -1.0, the NPRM proposals result in a reduction of market dominant mail volume to 103.9 billion, a reduction of 12.7 billion (10.9%) from Scenario 1a. The two alternatives also show volume reductions, but these are much smaller because their real price increases are much smaller.

Scenario 4: Cautious Above-CPI Price Increase (2% increase 1 time only)

Given the Service's essentially financial stable operations and the risk that the financial shock of continued above-CPI price increases could substantially reduce mail volume, it would be prudent for the PRC to consider above-CPI price increases that are much more cautious than those in the NPRM proposals. In Scenario 4, we show the result of an altered version of the NPRM proposals that includes an above-CPI increase of 2% for only one year. The TFP-linked portion of the NPRM proposals is continued as proposed. To reflect the real uncertainty about the true size of the price elasticity and the substantial danger associated with accelerating volume declines, this scenario is estimated using the parameter value of -0.7 for the price elasticity of demand for market dominant products.

In this final scenario, we also make changes to the alternatives so that the parameters related to the incentive effects are much smaller: the extra TFP growth from the incentive is assumed to be only 0.2 percentage points and the change in input price inflation is assumed to be only -0.2

percentage points. These are very small changes that are well within historical experience and well within the scope of management to bring about with concerted attention.

Table 4: Cautious Above-CPI Increase (2% increase 1 time only)

Above-CPI Price Increases	Net Balance Sheet Improvement Over 5 Years	Real Price Increase Over 5 Years	Projected Market Dominant Volume in 2023
NPRM Proposals – Only 1 year of 2%	\$5.7 billion	5.9%	112.4 billion
Controllable Cost Alternative – Small Efficiency/Price Effects	\$4.2 billion	1.0%	115.9 billion
TFP Alternative – Small Efficiency Effect	\$1.6 billion	0.5%	116.3 billion

Source: Reply Rate and Cost Changes.xlsx, Scenario 4 – 2% increase 1x

Table 4 shows the results of the Cautious Scenario. By substantially limiting the market dominant price increase above CPI, the volume reductions in Market Dominant mail are limited for all three approaches, while producing positive improvements in the net balance sheet over 5 years in all three cases. Of course, the two alternatives produce this improvement with smaller price increases and higher market dominant volumes by forcing part of the improvement to occur through higher efficiency and lower input price inflation.